A Transatlantic Perspective on the International Monetary System, Geopolitics and Fiscal Constitutions

9 June 2015

On 9 June 2015, the US Project at Chatham House hosted a breakfast discussion with Sir Paul Tucker, senior fellow at the Harvard Kennedy School and Harvard Business School, and former deputy governor of the Bank of England, on ‘A Transatlantic Perspective on the International Monetary System, Geopolitics and Fiscal Constitutions’. This event was part of an ongoing project, sponsored by Bank of America Merrill Lynch, which brings together senior representatives from many sectors to discuss US and European perspectives on common economic challenges.

The principal points from the discussion included the following:

- The prospective restructuring of the international monetary system will not only be an economic issue, but also a geopolitical one. The foreign policy community was intimately involved in the last major deliberate restructuring of the global economy at the Bretton Woods Conference in 1944, which formalized the transfer of the world’s reserve currency from the pound sterling to the US dollar. That reordering can potentially be seen as having been tied to a commitment by the United States to defend Europe and, later, to an accommodation with the domestic political and religious arrangements of the world’s main oil producers. The continued evolution of the international monetary system will be not be any less complex or multidimensional.

- However, countries often enter these transformational periods with relatively compartmentalized expertise due to decades of living under a settled regime. In order to meet the challenges that may lie ahead, economists and foreign policy professionals will need to engage more with each other to explore the geopolitical consequences of any restructuring; the perspectives of both sides are required.

- Many think that it will be decades before China’s renminbi becomes a reserve currency. That may be the case, but the pace of change will depend on unforeseeable developments. Countries with strong trade networks and surplus savings tend to want to underpin their economic power by having their currency used as a reserve currency. Also, as the global financial crisis of 2008–09 illustrated, issuing the world’s reserve currency reduces the domestic cost of even a home-grown crisis: US Treasury bill yields fell as funds rushed to the global ‘safe asset’, reducing the fiscal costs of the crisis for the US. Others might aspire to that structural insurance mechanism in due course. There is already a debate about whether the Chinese currency should be included in the basket for the Special Drawing Rights – whatever the practical implications, such a move would have some symbolic importance.

- Some observers – for example, Raghuram Rajan, the governor of the Reserve Bank of India – argue that today’s leading economies have a duty to take account of the effects of their macroeconomic and regulatory policies on the rest of the world. It is not yet clear what that would mean in practice, but the argument is being made with increasing force as emerging markets account for an ever larger share of the global economy.
Given the possibility that the world monetary system will become more multipolar, Western powers need to take a strategic approach to global economic and financial policy-making. This approach should be robust enough to accommodate the possibility that the present dominance of the US is sustained, but also the alternative possibility that a more multipolar power structure emerges. For now, that means that the US and Europe need to pursue regulatory and other policies which they could accept being imposed by other countries in the future.

It is difficult to see how any new order will remedy the problem that adjustments to big shocks in the global economy are asymmetric. States with significant surplus savings will still want countries with large external payments deficits to bear the brunt of any adjustment. That reflects genuine concerns about moral hazard, as well as the reality of the balance of power. Consequently, countries with large deficits are going to have to pay more attention to weaknesses in their national balance sheets. A significant question will be whether, faced with private-sector profligacy, governments will use their new macroprudential powers to enforce greater prudence and resilience; or whether they will choose to offset excess private borrowing by reducing state deficits. Thus, fiscal constitutions will need to be framed in the light of broader national macroprudential strategies. How international cooperation will work in that context adds an additional dimension of complexity to the evolution of the global economic order.

Another set of issues that will affect any new order will be the largely unforeseeable strategic interaction between monetary policy-makers and fiscal policy-makers. Monetary policy-makers have proved to have quite flexible tools, but also, crucially, they have mandates and objectives set by legislatures. Fiscal policy-makers, in contrast, can do almost anything but have no clear mandate or obligations. Even for countries with fiscal capacity, there are political ‘transaction’ costs to most overtly fiscal actions, including getting agreement within a political party and in the legislature. If, for those reasons, fiscal policy-makers with capacity are not proactive when faced with an economic slump, monetary policy ends up taking the full burden of generating recovery in the global economy. Although those are domestic ‘choices’, they have wider significance because of the potential costs of the cross-border risk-taking that is stimulated. Some strains in the current international monetary system are, therefore, sourced in the political economy of domestic regimes. That will add to the complexity of making sense of, let alone giving shape to, an evolving international order.

Seventy years ago the reformation of the international monetary and financial order was seen to be a geopolitical act, because it took place in the shadow of a global war. The challenges of today are hardly as momentous, but they are no less geopolitical. Our economic and financial policy-makers are foreign policy-makers too.